Seeking Alpha α

Predictions For 2017

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Making forecasts is of course foolish, but to a degree, it's necessary. It's important to have a view on both the economy and on what the market expects of the economy in order to invest with confidence - confidence being a key ingredient for successful long-term investing. For example, taking on risk when the market is risk averse is potentially more rewarding than taking on risk when the market demands a high price for it. In a nutshell, markets move when the future turns out to be different than what was expected, so it pays to have a view on what is expected and what is likely.

So that readers may judge how successful (or unsuccessful) I've been in this regard; it has been my custom for a number of years to annually review the success or failure of prior predictions while at the same time offering up predictions for the future.

First, a look at how last year's predictions turned out

I was generally optimistic, because I thought the market was still overly concerned about the economy's ability to grow, and because I thought the economy had lots of upside potential that could be unlocked with more growth-oriented policies. I thought the Fed would move very slowly to raise short-term interest rates. I wasn't at all convinced that Trump's policies would be good for the economy, since at the time, he was emphasizing a populist, trade-bashing approach, but I didn't rule out an improvement. As it turned out, optimism beat pessimism this past year, and I've been rewarded. The economy turned out to be a little better than the market expected.

I advocated holding risk assets, with an emphasis on yield. As it turned out, stocks with higher-than-average dividend yields handsomely outperformed the S&P 500, while almost anything beat the return on cash. I thought real estate would outperform, but it didn't, mainly because of the market's concern that higher yields would be bad for the sector. I thought the outlook for gold and commodities was grim because the outlook for the dollar was positive; however, to just about everyone's surprise (including mine), gold and, in particular, industrial commodities did well this past year despite the dollar's strong performance. I thought emerging markets were due for a strong recovery, and that paid off in spades (e.g., Brazilian equities rose almost 70% in dollar terms this year).

I worried once again (as I have for many years) that the Fed might prove slow to react to the return of confidence, and that as a result it could end up falling behind the inflation curve. So far, however, that doesn't appear to be the case, since inflation expectations remain relatively docile.

Here's what I see in my crystal ball for 2017

In contrast to the situation a year ago, when I thought the market was insufficiently optimistic, the market today appears more optimistic about the future (e.g., the S&P 500 PE ratio was 18.8 a year ago, and today it's 21). This sets the bar for investing success higher than it was a year ago. The market is priced to good, growth-oriented policies coming out of the Trump administration, so any fumbles along the way are likely to be met with selloffs (If there's anything we know about Trump, it's that he can confound expectations). But by and large, I expect he will pursue a pro-growth policy agenda, and this will contribute to a measurable and possibly a substantial improvement in the economy's growth. The going is likely to be bumpy at the outset, but over the long haul, I expect to see an improving economy and further gains in equity prices and most other risk assets.

I don't necessarily disagree with the market's view that the Fed will raise short-term rates by 50 bps next year. But I worry, as I have for years, that there's a decent chance the market - and the Fed - could be underestimating the degree to which rates should rise as the economy strengthens. The market expects inflation to be well-behaved at somewhere close to 2% for the foreseeable future; I worry it could surprise to the upside. The main driver of higher-than-expected inflation would be a decline in the demand for money. As I pointed out before, if the market's demand for money should decline because of rising confidence and less risk-aversion, there is a virtual mountain of cash sitting on the sidelines that could fuel higher prices, especially if the Fed is slow to take steps to increase the demand for money by raising short-term interest rates. Over the long haul, I think there's a decent chance that interest rates will move up by more than the market currently expects, so risk-free Treasuries don't look very attractive at current levels. The yield spread on riskier bonds has come down a lot over the past year, so while it is still attractive relative to Treasuries, it certainly isn't a steal and should be approached with a degree of caution.

I think the market worries too much about the negative impact that higher interest rates could have on real estate and the economy. That's because the market sees higher rates as a "tightening" of monetary policy (which to be sure is eventually bad since it's been the proximate cause of almost every recession), when in fact higher rates - for at least the next year - will simply be the natural result of a stronger economy. The time to worry about tight money is when real interest rates are 3% or more and the yield curve is flat or inverted, and we're a long way away from those conditions. Higher rates are not going to kill the real estate market, even though the market almost always reacts as if that's so. Real estate in general should benefit from stronger growth, and it should be a good hedge against rising inflation.

The dollar is fairly strong at current levels, because of several well-known factors: the Fed is the only major central bank that is in rate-hiking mode, and the U.S. economy has a lot more upside potential than almost every other major economy. But the dollar is not yet "too strong," nor is it likely to be a problem for the economy. The dollar is relatively strong because the U.S. economy looks more attractive than most others; if you want exposure to this relatively attractive economy, you're going to have to pay up to get involved. That's reasonable. This is not a situation in which the dollar is strong because there's a shortage of dollars in the world, and that is probably a good explanation for why commodities can continue to rise even as the dollar rises. It's about optimism and growth, not tight money.

A year ago I noted the impressive victory of Argentina's Macri, who, like Trump today, was set to move policies in a more pro-growth direction. Since then, we've seen pro-growth surprises in Brazil and the UK (Brexit), and there's likely more to come (e.g., Italy and France). The political winds are in fact shifting in a more pro-growth direction in many countries (a new and better government in Venezuela is almost a certainty), and that is a nice tailwind for most risk assets. Emerging markets still look good, despite the strong dollar, because, again, it's about the return of optimism and growth.

I don't have strong feelings about gold, but I do believe it is still expensive relative to its long-term average real price which I figure is somewhere around $500-600/oz., so I'm not keen on adding it to my portfolio. Oil seems reasonably priced at current levels, and it's unlikely to become too cheap or too expensive for the foreseeable future, thanks to plenty of fracking capacity that is currently on the sidelines and upside economic growth potential.

The important thing about Trump is that he is a businessman with experience in how things work in the real world; he's not an ideologue. He understands and appreciates the power of incentives, and he is distrustful of the power of government to accomplish good things. It's very encouraging that he understands the growth-damaging effects of regulations. He won't always do things "correctly," but he's likely to get good results.

My main concern with Trump is that he fails to understand the benefits of free trade, and his trade advisor, Peter Navarro, is exceptionally clueless in that regard. Whether the two of them can persuade a more trade-savvy Congress to impose punitive tariffs on imports is not clear, however. I'm hoping that their bark ends up being worse than their bite, and practical considerations trump rhetoric in the end. We don't need balanced trade (e.g., no trade deficits), but what we do need is freer trade. For that matter, the economy desperately needs less regulation, not more.

I'm not worried that a much-needed reduction in tax rates will balloon the deficit, because lower tax and regulatory burdens, plus fewer deductions and subsidies, should add significantly to the tax base. I seriously doubt that we'll see a major and foolish rush to spend money on infrastructure; what we need instead is for government to create incentives for more infrastructure spending at the private and local levels, where the risk/reward tradeoffs are best understood.